No. 11,160

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

BABETTE G. LURIE,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF.

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STATEMENT OF THE PLEADINGS.

Petitioner is a resident of San Francisco, California, and filed her income tax return for the year ending December 31, 1941, with the Collector of Internal Revenue for the First District of California at San Francisco. On the 22nd day of October, 1943, respondent issued a 90-day letter determining a deficiency of income taxes for said year in the amount of $1177.03. On the 6th day of December, 1943, petitioner filed a petition for redetermination of said deficiency with The Tax Court of The United States, which Court rendered its decision on the 31st day of March, 1945, determining the deficiency in said amount of $1177.03. On the 16th day of June, 1945, petitioner filed her petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of said

decision of said Tax Court. The jurisdiction of this Court to review the aforesaid decision of The United States Tax Court is founded on Internal Revenue Code Section 1141(a) (b) (1).

Petitioner claimed in her said income tax return for the year 1941 that the profit realized upon retirement of certain preferred income notes resulted in a long term capital gain. Respondent assessed an income tax deficiency for said year contending that the profit realized upon the retirement of said notes constituted ordinary income.

QUESTION PRESENTED.

When preferred income notes not in registered form, of a series issued by a corporation, are purchased by an individual taxpayer at less than face value and all of the outstanding notes are thereafter returned to the corporation to permit of a form of registration being printed on each and the registration thereof, is the profit on retirement of said notes a long term capital gain under the law as it existed in 1941 when the retirement occurred more than two years after acquisition of said notes by the taxpayer although less than 18 months after the form of registration was printed on each of said notes and each of them was registered?

SPECIFICATION OF ERROR.

1. The Tax Court erred in determining that Section 117(f) of the Internal Revenue Code has no application to notes converted into registered form less than 18 months before retirement with the result that the profit realized upon retirement was held to constitute ordinary income rather than a long term capital gain.

SUMMARY OF THE FACTS.

Petitioner purchased some preferred income notes of a series issued by Hilton Hotel Company of California, a corporation, at a discount. Subsequently the corporation requested that all of said series of said notes be returned to it so that they could be converted into registered form by printing on each a form of registration. All notes issued were so returned to the corporation and transmuted into notes in registered form and all were registered. During the following year but less than 18 months after such registration, the notes were retired at face value, resulting in a profit to petitioner.

STATEMENT OF THE FACTS.

All the facts in the case were presented to The Tax Court by stipulation. (T. p. 26.)

1. A series of preferred income notes was issued by Hilton Hotel Company of California, a corporation,

during the year 1938 in the total amount of $203,747.94. (T. pp. 26, 27.)

2. Said notes were issued pursuant to the permit of the Commissioner of Corporations. (T. pp. 26, 27.)

3. In 1938 and early in 1939 petitioner acquired units each of which included a certain percentage of all of the outstanding securities and obligations of said corporation. Included in each unit were preferred income notes acquired at less than face value, which notes are the subject of the instant matter. (T. p. 27.)

4. In the application to the Corporation Commissioner for the permit to issue said preferred income notes it was recited:

> "Said new promissory notes are to be registered and applicant hereby designates itself to act as the registrar thereof." (T. p. 28.)

5. Annexed to said application was a printed form of a preferred income note, a copy of which, designated Exhibit 1, is set forth in the transcript (T. p. 31) and an additional printed page entitled "Registration," on which was set forth a form for registering said notes. (T. p. 28.) When said notes were finally printed and issued said additional page on which said form for registration was printed, was omitted and they were in the form of said Exhibit 1. (T. p. 28.)

6. In August of 1940 the company requested of the holders of said notes that they be returned to it. (T. p. 28.) The notes were thereupon returned to the company and on the face of each of said notes was printed the following:

"Notice to Holder: This note may be registered as provided on the back hereof."

and on the back of each was printed the following:

"This note may be registered in the holder's name upon a register to be maintained by the Company at its office in San Francisco, California. Such registration shall be noted on this note by the Company, after which no transfer hereof shall be valid unless made on said register and noted on this note. The Company may deem and treat the person in whose name this note is from time to time registered as the absolute owner hereof for the purpose of receiving payments of principal and interest due hereon and for all other purposes.

(Registration)

Notice to Holder: Do not write on this note. Consult the Company for method of transferring registration.

Date of Registry.

.....

In Whose Name Registered.

.....

Register Hilton Hotel Company of California

By.....

Authorized Officer."

(T. pp. 28, 29.)

7. On August 6, 1940, the taxpayers returned to said corporation the notes involved in this action and had them registered in the name of Louis R. Lurie, husband of petitioner. (T. p. 29.)

8. All of the notes in question were retired in 1941, more than two years after the acquisition of them by the petitioner and less than 18 months after their registration as aforesaid, at a profit in the instance of petitioner in the amount of $3448.43. This profit was returned by petitioner as a capital gain. Respondent contends that said profit is ordinary income. (T. p. 30.)

SUMMARY OF THE ARGUMENT.

The preferred income notes were indisputably capital assets. Admittedly they were held for more than 18 months and so upon a sale or exchange of each of them the holder would be entitled to a long term capital gain. Section 117(f) of the Internal Revenue Code provides that the retirement of notes in registered form constitutes a sale or exchange and no mention is made in said section of the time of holding said notes; therefore the retirement of the notes in question constituted a sale or exchange and said notes being capital assets held more than 18 months, the difference between the purchase price and the amount received upon retirement constituted a long term capital gain.

ARGUMENT.

I.

THE NOTES ARE CAPITAL ASSETS HELD FOR MORE THAN TWO YEARS.

The term "capital assets" includes all classes of property not specifically excluded by Internal Revenue Code Section 117(a)(1),[1] regardless of the period for which such capital assets are held.[2] As stated in the opinion of The Tax Court "There is, and can be, no question raised as to the fact that the notes in question were capital assets under the statutory definition of Section 117(a)(1)." (T. p. 17.)

It is stipulated that the notes were acquired more than two years before retirement. (T. p. 27.)

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[1]Internal Revenue Code, Section 117(a)(1):

"(a) Definitions.—As used in this title—

(1) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with the trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1)."

[2]Regulations 103, Section 19.117-1:

"Meaning of terms.—The term 'capital assets' includes all classes of property not specifically excluded by (Code) section 117(a)(1). In determining whether property is a 'capital asset', the period for which held is immaterial."

II.

THE RETIREMENT OF THE NOTES, SINCE THEY WERE IN REGISTERED FORM, CONSTITUTED A SALE OR EXCHANGE.

Since the notes in question were capital assets and were admittedly held for more than two years, the sole issue is whether or not the retirement of said notes constituted a sale or exchange. If the retirement did constitute a sale or exchange the profit thereon would necessarily be a capital gain and since they were held for more than two years it would be a long term capital gain[3] as reported by the petitioner in her income tax return. Section 117(f) of the Internal Revenue Code as originally adopted in 1934 and

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[3]Internal Revenue Code, Section 117(a)(2) and Section 117(a)(4):

"(a) Definitions.—As used in this title—

* * * * * *

(2) Short-term capital gain.—The term 'short term capital gain' means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income.

* * * * * * *

(4) Long-term capital gain.—The term 'long term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income."

Internal Revenue Code, Section 117(b):

"(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months. * * *"

which has persisted in subsequent acts, and in the Internal Revenue Code, provides that the retirement of certain types of securities, including notes in registered form, constitutes a sale or exchange.[4] The principles of the capital gains and losses provision of the law must be clearly borne in mind: (a) The asset must be a capital asset; (b) the asset must be sold or exchanged; and (c) if the asset is held for a certain period of time the sale or exchange results in a long term capital gain or loss; if not so held, the sale or exchange results in a short term capital gain or loss.

In the instant case the provisions of (a) and (c) have been complied with so as to entitle the petitioner to claim a long term capital gain or loss; that is, the notes were capital assets and they were held for more than two years. The issue is narrowed down to only one limited question: Was there a sale or exchange of said notes?

Before answering that question petitioner must ask the indulgence of the Court for what may appear to have been an over-simplification of the capital gains and losses provision of the law but it is here that The Tax Court confused the issue. The last paragraph of The Tax Court's Opinion reads as follows:

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[4]Internal Revenue Code, Section 117(f):

"(f) Retirement of Bonds, Etc.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

> "In our opinion there can be no doubt that, taking all the provisions of section 117 into consideration and having due regard for the purposes of the section, to come within section 117(f) the notes must be, at the very least, in registered form for the minimum period provided by section 117(b). This period is 18 months. Since petitioners' notes were in registered form for less than such period before retirement, they do not qualify under section 117(f)." (T. p. 21.)

It would seem clear that the holding period has no relation whatsoever to the question of whether or not the retirement constitutes a sale or exchange. If the notes were held for less than 18 months the retirement would have been a sale or exchange but the gain would have been a short term one; if over 18 months a long term one. To say that the notes do not qualify under Section 117(f) is a misconception of the law, for Section 117(f) has no reference to the holding period of a capital asset. To hold otherwise would mean that the retirement of corporate coupon bonds in less than 18 months would not be a short term capital gain or loss but would result in ordinary income or loss.

We can only question whether or not The Tax Court would have reached the same conclusion and would have allowed an ordinary loss rather than a short term capital loss, were it presented with a situation involving a loss from retirement a few months after purchase of a corporate coupon bond.

If the petitioner had sold the notes after she had held them for two years but prior to retirement, and even in anticipation thereof, the transaction would necessarily have been a long term capital gain.

McKee v. Commissioner, 35 B.T.A. 239 (acq.);
Hobby v. Commissioner, 2 T.C. 980 (acq.).

Under Section 117(f) retirement is the equivalent of a sale or exchange.

The history of the effect of retirement of bonds and registered notes is set forth in The Tax Court's Opinion in which reference is made first to the case of *Werner v. Commissioner,* 15 B.T.A. 482, which held that retirement of bonds constituted a sale or exchange. Some years later this case was overruled in *Watson v. Commissioner,* 27 B.T.A. 463. From that time on until the enactment of Section 117(f) in 1934 it was settled that the retirement of bonds did not constitute a sale or exchange. *(Fairbanks v. United States,* 306 U. S. 436, 59 S.C. 66, 83 L. Ed. 855; *Commissioner v. Caulkins,* 6th Cir., 144 F. (2d) 482.)

It would appear that the obvious purpose of the section was that profit or loss received upon retirement of a security should be a capital transaction while profit or loss on the payment of an ordinary obligation should be ordinary income or loss. In the instant case, a series of preferred income notes was issued pursuant to a permit of the Commissioner of Corporations of the State of California. These notes were in printed form. Although the application to the Corporation Commissioner evidences the intention of

the corporation that the notes were to be issued in registered form, for some undisclosed reason this was neglected. Nevertheless the purchase of said notes, particularly when acquired as a portion of a unit containing other securities, would ordinarily be deemed by any investor to be the acquisition of securities. Had they at no time been in registered form the retirement necessarily could not have been considered a sale or exchange but that would have been due to the force of Section 117(f). Further restricting the meaning of Section 117(f) would result in placing an unwarranted limitation upon normal business transactions without reason therefor. It is submitted that such was not the intention of Congress but that the sole restriction that notes must be in registered form was inserted primarily to differentiate between a note susceptible to registration and the ordinary promissory note, so that payment of an ordinary obligation in the normal course of business would not result in a capital gain or loss.

It should be noted that the question of determining the effect of a sale or exchange of an asset is controlled by the conditions in existence at the date of the sale or exchange. The Commissioner of Internal Revenue has always recognized that the holding period for residential property subsequently converted into business property commenced not at the time of conversion but at the time of the original acquisition of the property. (See I.T. 3041, 1927-1, C.B. 148, followed in *Kimbell v. Commissioner,* 41 B.T.A. 940.)

When a capital asset has been exchanged in a non-taxable exchange the holding period commences from the time of acquisition of the original asset under Internal Revenue Code Section 117(h)(1).[5] In the instant case, even though the return of the notes to the corporation for change to registered form and registration be deemed to be an exchange (and no contention is made by the Commissioner that it was or could be a taxable exchange) then the holding period still reverts to the original date.

In the recent case of *Gracey v. Commissioner,* 5 T.C. 296, The Tax Court held that even though an asset which was not a capital asset was converted by a non-taxable exchange into a capital asset a few months prior to sale, the sale of such asset resulted in a long term capital gain.

As stated in the case of *Commissioner v. Caulkins,* supra, "Where statutory standards are lacking, statutory language is to be read in its natural and common meaning." It has been shown that under the natural and common meaning of Section 117(f) the retirement of the registered notes in question constituted a capital gain. However, The Tax Court endeav-

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[5]Internal Revenue Code, Section 117(h)(1):

"(h) Determination of Period for Which Held.—For the purpose of this section—

1. In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged."

ored to read into the law that which does not appear therein and gives as an excuse therefor that the literal language of the Code would allow taxpayers to determine for themselves whether to take a capital gain or loss merely by last-minute registration by the holder of a particular note. (T. p. 20.) (It must be noted that there is no finding or evidence that any effort to avoid taxes was involved in the present case.) The Tax Court again misconceives the clear language of Section 117(f). Whether a particular holder of a note registers it or not has no tax consequence. The only issue is whether or not the notes were in registered form. Even so, as above explained, the holder could always sell the note before retirement and thus procure a capital gain; thus in the instant case if the petitioner, instead of relying upon the clear unequivocal language of Section 117(f) had sold the notes before retirement the respondent would not have questioned the fact that a capital gain resulted. There is no justification for The Tax Court endeavoring to change the clear language of Section 117(f) so as to include therein an additional requirement relating to the holding period of the asset.

CONCLUSION.

It is respectfully submitted:

1. That the preferred income notes in question were capital assets; (Internal Revenue Code, Section 117 (a)(1).)

2. That said assets were held by the petitioner for more than two years; (Internal Revenue Code, Section 117(a)(4).)

3. That the retirement thereof constituted a sale or exchange. (Internal Revenue Code, Section 117(f).)

Therefore petitioner properly reported her income from the transaction and the decision of The Tax Court should be reversed.

Dated, San Francisco, California,
December 24,1945.

Respectfully submitted,
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